No. 13,804

In the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

EDWARD D. SULTAN, RESPONDENT.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

v.

OLGA L. SULTAN, RESPONDENT.

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

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CITATIONS

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OPINION BELOW

The opinion of the Tax Court (R. 159-178) is reported at 18 T. C. 715.

JURISDICTION

The petitions for review in these cases involve~~s~~ deficiencies aggregating $406,452.34 in the federal income taxes of the taxpayer Edward D. Sultan and his wife [1]

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[1] The taxpayer's wife is involved only because of the community property law of Hawaii which became effective on June 1, 1945. (R. 160.)

for the years 1944 through 1946. (R. 5, 26, 179-191.) On April 26, 1949,[2] the Commissioner of Internal Revenue mailed to the taxpayer and his wife notices of deficiencies in their income taxes for the years in question. (R. 14, 34.) Within 150 days thereafter, on August 12, 1949, the taxpayer and his wife, pursuant to Section 272 of the Internal Revenue Code, filed petitions with the Tax Court for redetermination of such deficiencies. (R. 4-24, 26-37.) The proceedings were consolidated for hearing in the court below. (R. 2, 4.) On October 31, 1952, decisions of the Tax Court were entered redetermining the deficiencies. (R. 179, 180.) On January 10 and 19, 1953, the Commissioner filed his petitions for review invoking the jurisdiction of this Court under Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948. (R.181-187.)

QUESTIONS PRESENTED

1. Whether in transferring property in trust for the benefit of his minor son the taxpayer retained sufficient control over that property to be treated for tax purposes as the recipient of income therefrom when (a) the trust was required to use that property to purchase a special or limited partner's interest in a simultaneously created family partnership in which the taxpayer was the controlling general partner, and (b) the trust was not free to terminate or transfer its interest once the partnership was created.

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[2] There were added to the gross income of the taxpayer and his wife for each of the years in question amounts in excess of 25 per cent of the gross income stated in their returns. (R. 16, 19, 22, 35.) Accordingly, under Section 275(c), Internal Revenue Code, assessment and collection of the deficiencies were not barred by the statute of limitations.

2. Whether a trust, which the taxpayer claims should be recognized for tax purposes as a special or limited partner solely on the basis of its contribution of gift capital to the partnership, was the true owner-contributor of such capital when it was not free to withhold such capital from the partnership, to transfer the partnership interest allegedly acquired for that capital, or to withdraw from the partnership either the capital or income attributable to it.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and Regulations are set forth in the Appendix, *infra.*

STATEMENT

The facts found by the Tax Court, which are based in part upon a stipulation (R. 43-158) may be summarized as follows:

The taxpayer, Edward D. Sultan, and his wife, Olga, were residents of the Territory of Hawaii. They had one child, Edward D. Sultan, Jr. born December 28, 1927. (R. 160.)

The taxpayer had been in the wholesale jewelry or jewelry manufacturing business since he was about 10 years old. In the early part of 1941, he was in the wholesale jewelry business as an individual in Honolulu. That business consisted of dealing in watches, diamonds, silverware, general jewelry lines, and everything associated with a jewelry business (R. 160.) The taxpayer was primarily a salesman. The manager of the business was his brother, Ernest W. Sultan, who received as compensation 25 per cent of the net profits of the business. The taxpayer devoted most of his time to selling in the Far East and in the Pacific Islands. Ernest had no financial interest in the business but was very valuable to it because of his knowledge of the jewelry business. (R. 160-161.)

For some time prior to August 1941, the taxpayer had been considering ways and means of protecting his family in the event of his illness or death, and also of interesting his son in the business. The son, who was 13 years old in 1941, was interested in the study of journalism and not in the jewelry business. The taxpayer at that time was almost constantly in the care of doctors. In 1940, while the taxpayer was on a trip, his brother Ernest became seriously ill and was away from the office for a few weeks. (R. 161.)

Another brother of the taxpayer, Gabriel, was a full time salesman of the taxpayer's merchandise in California. The taxpayer's sister, Marie Hilda Cohen, was in San Francisco, where she and her husband owned a warehouse and they frequently supplied warehouse space for the taxpayer's merchandise while it was awaiting shipment to Honolulu. In the early part of 1941, it was difficult to obtain shipping space. The taxpayer's sister was a capable business woman. (R. 161.)

The taxpayer discussed with his brothers and sister possible methods of having his business carried on for the protection of his wife and son and of interesting his son in the business. He also discussed the matter with his wife, with a relative in the United States who was a lawyer, and with counsel in Honolulu. Out of these discussions there was evolved the idea of the creation of a trust and the formation of a partnership. The taxpayer knew of one instance in which a jewelry business which was in bad financial shape had been rehabilitated under the management of a trust company. He wanted a trust company as trustee of the trust to be created for his son for the benefit of the advice which it could give and for the management which it could provide in the event he was not ~~un~~able to carry on the business. He wanted his brothers and sister associated with him in the business for the assistance they could give as they had in the past. (R. 161-162.)

The Bishop Trust Company, an Hawaiian corporation, conducted a trust company business in the Territory of Hawaii. Its main business was the administration of estates, trusts, guardianships, agency accounts, and it acted as transfer agent, and did similar business. In its fiduciary capacity, it often operated businesses in connection with its administration of estates or trusts. (R. 162.)

On August 28, 1941, the taxpayer created the Edward D. Sultan Trust, naming as trustees Ernest W. Sultan and Bishop Trust Company. The trust instrument recited the delivery to the trustees of the sum of $42,000 by the settlor, to be used to purchase a 42 per cent interest in a partnership known as Edward D. Sultan Company. Income was to be accumulated until the settlor's son became 21 years of age, but with discretion in the trustees to pay out not more than $3,600 per year for the maintenance, support and education of the beneficiary. Beginning at the age of 21, the beneficiary was to receive $300 per month; at the age of 25 he was to receive a portion of the accumulated income in a lump sum. At the beneficiary's age of 30 years, the trust was to terminate and he was to receive the trust corpus, together with any cash in the estate not in excess of $20,000. Any remaining cash was to be used to purchase an annuity for the beneficiary. If the beneficiary died before the age of 30, corpus and income were to go to the wife of the settler, or, in the event of the happening of specified events, to the settlor's sister and brothers. (R. 162-163.)

The trust instrument gave the trustees the usual powers to hold and manage the trust property, collect the income, and invest and reinvest. The trustees were not restricted to investments of the type which are permitted by law, with the provisos that during the lifetime of the settlor the trustees were to obtain the settlor's consent to investments, and upon the settlor's death they were to be restricted to legal trust investments. However, the trustees could in any event make loans or advances to the partnership without liability for resulting losses. The trust was irrevocable. The corporate trustee was given custody of all money and securities in the trust estate. The settlor reserved the right to transfer additional property to the trust. Under the terms of the trust instrument neither the corpus nor income of the trust was ever to be paid to the settlor. The trust was conditioned upon obtaining court approval for the purchase of a 42 per cent interest in Edward D. Sultan Company, and approval of the trustees becoming a special partner therein. If such approval was not obtained within 60 days, the trust indenture was to be null and void. (R. 163-164.)

On August 30, 1941, a partnership was formed under the name of Edward D. Sultan Company. It was a special partnership. The general partners were the taxpayer, Ernest W. Sultan, Marie Hilda Cohen, and Gabriel L. Sultan. The trustees of the Edward D. Sultan Trust were a special partner. The initial capital of the partnership was $100,000. (R. 164.) Contributions of capital and partnership interests were as follows (R. 164):

Partner	Contribution	Interest
Edward D. Sultan	$46,000	46%
Ernest W. Sultan	4,000	4%
Marie Hilda Cohen	4,000	4%
Gabriel L. Sultan	4,000	4%
Trustees of Edward D. Sultan Trust	42,000	42%

The partnership was to acquire the assets and carry on the business theretofore conducted by Edward D. Sultan. The general partners actively engaged in the business were to receive compensation for services rendered in such amounts as the general partners might agree on, and such compensation was to be charged as an expense in computing net profits. As long as Ernest W. Sultan was active in the business, he was to receive 25 per cent of the net profits. The remainder of the profits was to be divided in proportion to the capital contributions of the partners. The provision for Ernest W. Sultan to receive 25 per cent of the net profits was stricken from the agreement by amendment dated June 9, 1942. Profits could be withdrawn at such time as the general partners deemed advisable. (R. 164-165.)

Only the general partners had authority to transact partnership business and incur obligations. The policy of the partnership was to be established by the general partner or partners owning the majority in interest of the capital. No general partner could assign or mortgage his or her interest, but any partner could purchase the interest of any other partner. The special partner could assign its interest with the consent of the general partners. (R. 165.)

Proper partnership books of account were to be kept. The books were to be audited periodically and copies of auditors' reports were to be furnished to each partner. Annual accounts were to be taken showing the interest of each partner and copies thereof were to be sent to each. (R. 165.)

The partnership could be terminated by a majority in interest of the general partners on two months' written notice. The taxpayer had the option to purchase the interest of any deceased general partner or of any partner who gave notice of termination. Such purchase was to be the book value without allowance for good will. (R. 165.)

Originally the partnership was to continue until April 30, 1943, and thereafter from year to year until terminated by a general partner on six months' notice. By amendment dated February 2, 1945, the term was extended to January 31, 1946, and thereafter from year to year. (R. 165.)

By bill of sale dated as of the close of business on August 30, 1941, the taxpayer transferred to the partnership all of the rights, property, assets, privileges, and business formerly carried on by him, having a stated value of $100,000. He received back demand notes made by him on August 28, 1941, payable to the trustees of Edward D. Sultan Trust in the amount of $42,000 and to Ernest W. Sultan, Marie Hilda Cohen, and Gabriel L. Sultan, each in the amount of $4,000. He also received a 46 per cent interest in the partnership. (R. 165-166.)

The required certificate of partnership and affidavits were filed and publication was duly made. (R. 166.)

On September 5, 1941, the trustees of the Edward D. Sultan Trust filed in the First Circuit Court of the

Territory of Hawaii a petition to become a special partner in Edward D. Sultan Company and to invest $42,000 in the partnership for a 42 per cent interest therein. On September 9, 1941, the court entered an order in which it instructed, authorized, and directed the trustees to become a special partner in the partnership and to invest $42,000 therein. (R. 166.)

On or before March 15, 1942, the taxpayer filed a gift tax return for the year 1941 in which he reported a gift of $42,000 to the Edward D. Sultan Trust. The Commissioner determined that the value of the 42 per cent interest in the partnership was greater than the reported amount of $42,000 and that additional gift tax was due in the amount of $81.99 which amount the taxpayer paid. (R. 166.)

Ernest W. Sultan managed the partnership business until he became ill in 1942 and was required to leave the islands. The taxpayer at that time took over the management. Ernest recovered quickly and, at the request of the taxpayer, opened a buying office in New York for the partnership and continued in the service of the partnership as a buyer. (R. 166-167.)

The corporate trustee was given annual auditor's statements of the partnership business, and the taxpayer gave it oral interim statements. The taxpayer discussed business policies with officers of the corporate trustee, and conferred frequently with the other trustee on partnership matters. (R. 167.)

The partnership made it a regular practice to pay for merchandise on the day of receipt of the invoice even though delivery to it was delayed, sometimes for months, due to the demand for shipping space and restrictions on shipment by parcel post. This practice, and an expansion of the business following the outbreak of World War II, brought about a need for more capital in the business. In order to provide the needed capital and to improve the partnership's credit rating, the partners agreed in 1942 or 1943 to leave earnings in the amount of $100,000 in the business to be used as working capital. This matter was discussed with officers of the corporate trustee. (R. 167.)

The taxpayer and his brother Ernest W. Sultan received compensation for services rendered to the partnership for the periods and in the amounts as follows (R. 167-168):

	Edward D. Sultan	Ernest W. Sultan
Sept. 1, 1941 to Jan. 31, 1942	$ 6,500.00	$23,000.00
Feb. 1, 1942 to Jan. 31, 1943	20,431.13	95,169.99
Feb. 1, 1943 to Jan. 31, 1944	42,000.00	60,000.00
Feb. 1, 1944 to Jan. 31, 1945	42,000.00	60,000.00
Feb. 1, 1945 to Jan. 31, 1946	42,000.00	50,000.00
Feb. 1, 1946 to Jan. 31, 1947	64,000.00	15,000.00

During the existence of the special partnership, the trustee was quite insistent on having the special partner's distributive share of profits paid over to it as soon as possible after financial statements were prepared. Payments of the trust's distributive share of the partnership profits were made to the corporate trustee as follows (R. 168-169):

Payments made		Payments made	
June 23, 1942	$ 24,754.29	March 12, 1945	$83,029.40
March 15, 1943	2,000.00	March 17, 1945	50,000.00
March 23, 1943	108,913.64	March 21, 1945	25,000.00
October 8, 1943	2,198.94	April 6, 1946	42,000.00
March 15, 1944	16,640.00	May 21, 1946	99,698.24
June 14, 1944	19,000.00	January 14, 1949	2,155.75
September 2, 1944	21,000.00	March 14, 1949	10,000.00
September 21, 1944	97,457.03	April 28, 1949	85,357.62

In 1948, the partnership business fell off, due partly to increased competition. In January, 1949 the taxpayer purchased the interests of the three other general partners, namely, Ernest W. Sultan, Marie Hilda Cohen, and Gabriel L. Sulton. A formal bill of sale was executed wherein the three selling partners agreed to the termination of their interests in the partnership. (R. 169.)

In February, 1949, the taxpayer offered to purchase, and the trustees of the Edward D. Sultan Trust agreed to sell, the trust's interest in the partnership. The price agreed upon, in an exchange of letters, was a sum equivalent to the capital investment in the partnership, plus the amount of the unpaid profits accumulated to January 31, 1949. At that time, the beneficiary of the trust, Edward D. Sultan, Jr., had attained his majority, and had been active in the partnership business during his summer vacations from college. (R. 169.)

The officers of the corporate trustees gave thorough consideration to the taxpayer's offer before accepting it. They were aware of the need for additional capital in the business and of the possible decrease in the business of the partnership. They decided that it would be to the best interest of the trust to sell its share of the partnership to the taxpayer. The cotrustee, Ernest W. Sultan, approved the sale. (R. 169.)

The agreement was carried out through the medium of a bill of sale whereby the taxpayer and the trustees of the Edward D. Sultan Trust, as the "seller", sold the assets and business of the partnership to a new partnership known as Edward D. Sultan Company, in which the partners were the taxpayer, his wife Olga, and Edward D. Sultan, Jr. (R. 169-170.)

The new partnership started with a capital of $250,000. Of this amount, the taxpayer contributed $127,500, the taxpayer's wife contributed $60,000 from her own funds, and Edward D. Sultan, Jr., contributed $62,500.

The son, Edward D. Sultan, Jr., obtained the amount of his contribution by way of a loan made to him by the Bishop Trust Company, from the corpus of the Edward D. Sultan Trust. The money was loaned on the note of the son, which note was endorsed by both the taxpayer and his wife. As additional security for the loan, Edward D. Sultan, Jr., assigned to the trust company his remainder interest in the trust and his right to monthly payments of $300 which began when he reached the age of 21 years. The taxpayer never received from the trust any of its income. During the years involved in these proceedings, the taxpayer Edward D. Sultan supported his wife and son from his own income. (R. 170.)

At August 28, 1950, the end of the last fiscal year of the trust prior to the hearing in these proceedings, the trustees of the Edward D. Sultan Trust held intact the corpus of the trust estate, which consisted of the following items: cash, $9,842.58; United States Government Bonds, $171,872.61; note receivable of Edward D. Sultan, Jr., $60,782.14, the total of which amounted to $242,497.33. (R. 170-171.)

The Edward D. Sultan Trust duly filed fiduciary tax returns each year and paid the tax shown to be due thereon. The partnership, Edward D. Sultan Company, filed its partnership tax returns on an accrual and fiscal year basis ending on the 31st day of January. Its first return was filed on that basis for the fiscal year ended January 31, 1942. Returns on that basis were filed for subsequent years ending January 31, 1943 to 1949, inclusive. (R. 171.)

By virtue of the Hawaii community property law, which became effective as of June 1, 1945, the taxpayer's wife Olga was entitled to one-half of all of the income of her husband, the taxpayer, from and after that date. The entire deficiency proposed against her arose by reason of her community property interest in the income of her husband. (R. 171.)

The Edward D. Sultan Trust was a bona fide trust created for the benefit of Edward D. Sultan, Jr., and the taxpayer and his wife did not have any substantial control over, or interest in, the corpus or income thereof. (R. 171.)

The taxpayer, Ernest W. Sultan, Marie Hilda Cohen, Gabriel L. Sultan, and the Edward D. Sultan Trust really and truly intended to join together for the purpose of carrying on the business of Edward D. Sultan Company and sharing in its profits and losses. (R. 171.)

On the basis of these findings, the Tax Court, five judges dissenting, held that the Commissioner erred in including the Edward D. Sultan Trust's distributive share of partnership income in the income of the taxpayer and his wife. (R. 177-178.)

STATEMENT OF POINTS TO BE URGED

The points upon which the Commissioner relies as the basis for this proceeding are set forth at pages 187-191 of the record. In substance, they are that the Tax Court clearly erred in holding that the taxpayer did not retain sufficient control over the property which he had purportedly given away to remain taxable on the income attributable to that property and in holding that the donee-trust was the true owner-contributor of the gift capital upon which its claim of partnership status was based.

SUMMARY OF ARGUMENT

It is well established that the mere assignment of the right to receive income does not insulate the assignor from tax liability. Accordingly, where the assignor of income-producing property actually retains control over that property and merely parts with the right to receive income therefrom, he is properly treated for tax purposes as the recipient of such income. Applying this principle in *Toor* v. *Westover,* this Court has held that a combination of a trust and a limited partnership may serve as the means by which an assignor retains control over property which he has purportedly given away. There the taxpayer assigned in trust for the benefit of his minor children property which the donee-bank was required to use to become and remain a limited partner in a partnership in which the taxpayer was the controlling general partner. This Court held that the taxpayer in that case remained the substantial owner of the assigned property because of the following crucial facts: (1) the donee was not free to remain out of the partnership, (2) the donee was not free to terminate the partnership or transfer its interest therein, and (3) the donor, as controlling general partner, retained the powers of management and full discretion as to time and amounts of distributions of profits. In the case at bar we have an almost identical factual pattern—the trustees were not free to remain out of the partnership; they were not free to terminate the partnership or transfer their interest as special or limited partner; the donor, as controlling general partner, retained the powers of management and control over the time and amounts of distributions of profits. The Tax Court erred, therefore, in holding that in transferring property in trust for the benefit of his minor son the taxpayer did not retain sufficient control over that property to be treated for tax purposes as the recipient of income therefrom.

To have acquired partnership status for tax purposes an alleged partner must have contributed to the partnership one or both of the ingredients of income—capital or services. Where partnership status is based solely on the contribution of gift capital, the alleged partner must have been the true owner-contributor of that capital. As a special or limited partner the trust in the case at bar could not have contributed services to the conduct of the partnership business. Moreover, it was not the owner-contributor of the gift capital because it was not free to withhold such capital from the partnership, to transfer its interest in the partnership, or to withdraw either the gift capital or the income attributable to it. The Tax Court erred, therefore, in holding that the trust was entitled to recognition as a partner for tax purposes.

ARGUMENT

I

The Tax Court Erred in Holding that in Transferring Property in Trust for the Benefit of His Minor Son the Taxpayer Did Not Retain Sufficient Control Over that Property To Be Treated for Tax Purposes as the Recipient of Income Therefrom

It is well settled that, no matter how skillfully the assignment may be devised, a taxpayer cannot avoid income taxes by assigning income-producing property and the income therefrom [3] if he retains sufficient control over either the property producing the income or the receipt of the income so produced to make it reasonable to treat him as the recipient of the income

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[3] Of course, an assignment of income which will be or has been earned by the assignor's services is also ineffective to relieve him of tax liability. *Lucas* v. *Earl*, 281 U. S. 111; *Helvering* v. *Eubank*, 311 U. S. 122, rehearing denied, 312 U. S. 713.

for tax purposes. Thus, as stated by the Supreme Court in *Commissioner* v. *Sunnen,* 333 U. S. 591, 604:

> Nor is the tax problem with which we are concerned necessarily answered by the fact that such property, if it can be properly identified, has been assigned. The crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes.

An assignor may retain control over the property producing the income or over the receipt of income so produced by any of a number of means or combinations of means. In each case the test whether such control has been retained depends upon the end result and not upon any isolated step or steps in a series of related transactions. *Helvering* v. *Clifford,* 309 U. S. 331; *Helvering* v. *Stuart,* 317 U. S. 154, rehearing denied, 317 U. S. 602; *Commissioner* v. *Sunnen, supra; Toor* v. *Westover,* 200 F. 2d 713 (C. A. 9th), certiorari denied, 345 U. S. 975; *White* v. *Fitzpatrick,* 193 F. 2d 398 (C. A. 2d). To be taxable on the basis of his retention of control over the income-producing property or over receipt of the income therefrom it is necessary only that the assignor have retained the right to exercise such control and not that he have actually exercised that right. *Helvering* v. *Stuart, supra,* pp. 170-171; *Commissioner* v. *Sunnen, supra.*

On its facts the case at bar most closely resembles *Toor* v. *Westover, supra.* That case involved a combination of trust and limited partnership agreements, under either of which alone the assignor might not have retained sufficient control to be taxed as the owner of the income-producing property. This Court in its opinion, however, pointed out the significance of the package arrangement, holding that the assignor's control, stemming in part from the trust provisions and in part from the limited partnership agreement, was sufficient to render him taxable as the owner of the property which he had purportedly given away. In the case at bar we also have a package arrangement of a trust and a special or limited partnership. The majority of the court below in their analysis of the case, however, apparently did not focus on the end result of the partnership-trust arrangement but, treating each separately and ignoring or viewing as immaterial critical facts found by it, held that the parties to the original partnership agreement really and truly intended to join together for the purpose of carrying on the business and that under the provisions of the trust the taxpayer-settlor did not retain sufficient control to be treated as the recipient of the income for tax purposes. In this manner, we submit, the Tax Court reached a clearly erroneous conclusion.

In the *Toor* case a bank was the sole trustee for the taxpayer-settlor's minor children. There, this Court, disagreeing with the rationale of the District Court, pointed out (p. 716) that the question in issue turned on "whether in reality the bank as trustee for the minor children became the substantial owner of an interest in the capital of the alleged partnership." This Court then enumerated as follows the factors determining that question (pp. 716-717):

> Finding of Fact 15 in part states: "The partnership was not to terminate until 1955 and the interest of the limited partner was also stated to

be not transferable. But the plaintiff had the right to terminate the arrangement upon giving a thirty day notice of intention to dissolve it and he had the absolute right to purchase the interest of the limited partner at 'book' value." It thus appears that upon organization of the partnership the bank surrendered dominion over the money invested until 1955. It has been held that a family partnership will not fail merely because the donee is not free to dispose of his partnership interest. As said in *Middlebrook, Jr.,* 13 T. C. 385, where such a situation existed: "Partnership is a relationship arising out of contract. The partners may enter into an agreement between themselves with respect to their rights and interests which they deem proper." 13 T. C. at 394. In the instant case, however, *the donee was neither free to remain out of the partnership nor free to terminate or transfer his interest once the partnership was created.* The District Court's Finding of Fact 12 states: "The trust and limited partnership agreements were presented to the Bank by plaintiff as one package." We understand this to mean that the creation of the trusts was conditional upon organization of the partnership. Although the bank may have carefully investigated appellant and his business prior to assenting to becoming trustee, at no time subsequent to the creation of the trusts could the bank as trustee exercise independent judgment to determine whether it would or would not join in organizing the partnership. Because the bank was required to enter the partnership as a condition to creation of the trusts, and because of the further limitation that once the partnership was organized the bank was neither free to transfer its interest nor terminate the partnership, it cannot be said that the bank, as trustee, ever acquired such control as that which constitutes the usual attribute of property ownership. Considering these circumstances in connection with the fact that the appellant, as general manager, retained the powers of management and full discretion as to time and amounts of distribution of profits, we conclude that the appellant remained the substantial owner of the interest he purported to have given away. Cf. *Helvering* v. *Clifford,* 1940, 309 U. S. 331, 60 S. Ct. 554, 84 L. Ed. 788.

In the case at bar we have an almost identical factual pattern.[4] The donee in this case also "was neither free to remain out of the partnership nor free to terminate or transfer his interest once the partnership was created." The donee-trust was not free to remain out of the partnership because of paragraphs lettered (a) and (o) of the trust indenture. Paragraph lettered (a) provided that the trustees should use the entire amount transferred to them by the settlor to purchase a 42 per cent interest in the partnership and that they should continue to be a special or limited partner. (R. 52.) Paragraph lettered (o) provided that if court approval of such purchase and of the trustees' continuing to be a special partner was not obtained within 60 days, the trust indenture would be null and void. (R. 60-61.) The donee-trust was not free to terminate the partnership because of paragraphs numbered 11 and 18 of the special partnership agreement. Paragraph numbered 11 provided that the partnership

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[4] The similarity should also be noted between the instant case and the cases of *Commissioner* v. *Brodhead,* No. 13,805, and *Commissioner* v. *Eaton,* No. 13,806, now pending on appeal to this Court, in each of which cases the taxpayers were represented by the same counsel and the same type of trust indentures and special partnership agreements were employed.

could be determined or terminated by a "majority in interest of the General Partners," defined therein to mean the taxpayer only. (R. 80.) Paragraph numbered 18, in its original form and as amended January 12, 1942, and February 2, 1945 (Exs. 7 and 9), provided that the general partners (the taxpayer and his brothers and sister) could continue the partnership indefinitely. (R. 87, 107, 121.) The donee-trust was not free to transfer its interest in the partnership because of paragraph numbered 8 of the special partnership agreement. Paragraph numbered 8 provided that the special or limited partner (the donee-trust) could assign its share or interest in the partnership only with the consent of the general partners who had full power and discretion to give or withhold such consent. (R. 78.) Moreover, paragraph numbered 7 of the special partnership agreement provided that, except as otherwise stated in the agreement, the determination of the taxpayer, as the owner of the majority in interest of the capital contributed by the general partners, would be binding upon the partnership and would establish the policy of the partnership (R. 77); paragraph numbered 4 provided that only such portion of the profits attributable to a partner's interest could be withdrawn from the partnership as the general partners might deem advisable (R. 75).[5] Thus, as stated in the opinion of the five judges dissenting below (R. 178):[6]

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[5] Paragraph numbered 4 provided that the amount of distributive net profits would be arrived at after deducting the compensation of general partners actively engaged in the business in amounts from time to time agreed upon by the general partners, constituting the reasonable value of their services. (R. 75.)

[6] The split decision of the Tax Court in the case at bar was referred to by this Court in *Toor* v. *Westover, supra*. There, this Court, pointing out that the cases were similar, stated (p. 717) that it was not persuaded by the reasoning of the Tax Court in this case.

> Here the trust was compelled to use the alleged gift to acquire an "interest" in the business; had no control of the property; could not sell or dispose of it; could not freely withdraw profits; was confined to its investment in the partnership business; and compelled to retain that investment unless the will of the general partners, including petitioner, permitted otherwise.

Accordingly, for tax purposes the assignor in the case at bar, as in *Toor,*[7] remained the substantial owner of the partnership interest which he purportedly had given away.

In *Helvering* v. *Horst,* 311 U. S. 112, the Supreme Court stated (p. 119):

> We have held without deviation that where the donor retains control of the trust property the income is taxable to him although paid to the donee.

The trust property in the case at bar was the taxpayer-settlor's demand note in the amount of $42,000. The trustees, however, did not acquire the usual attributes of ownership with respect to this property. They were required to invest it in the partnership; as a limited partner, they had no voice in the use of their investment; and they were not free either to withdraw or transfer their interest. The taxpayer-settlor, on the other hand, retained complete control over the trust property which he had purportedly given away. He was assured that it would immediately be returned for use in the business which he controlled. The partner-

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[7] In the *Toor* case the trustee-bank apparently acted completely in a fiduciary capacity. In the instant case, however, paragraph lettered (l) of the trust indenture provided that the trustees would not be answerable or accountable for any loss or damage resulting from any act consented to by the taxpayer-settlor. (R. 59.)

ship which he dominated could also use it in any other business. Its use was to be without restriction by the donee-trust—because the donee-trust was only a special or limited partner. Its continued availability was assured because the donee-trust was not free to withdraw or transfer its interest. The other general partners were the taxpayer's own brothers and sister who also owed their interest to gifts from the taxpayer. He could at any time buy out any of the others at book value plus their share of undistributed profits. He could continue the partnership indefinitely and it could likewise be continued by his personal representative upon his death. Determinations of the taxpayer, as owner of the majority in interest of the capital contributed by the general partners, were binding upon the partnership and he established the policy of the partnership. By his purported transfer of property in trust for the benefit of his minor son, therefore, the taxpayer in reality [8] merely parted with the right to

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[8] Paul, Partnership in Tax Avoidance, 13 George Washington L. Rev. 121, 142-143 (1945):

> If we would truly orient the subject under discussion, we should recognize that the family partnership problem cannot be successfully treated as a local disease. Family trusts, family partnerships, family corporations, are in one sense all the same thing. They all may seek to reduce taxes by splitting, postponing, or otherwise controlling the receipt of taxable income without a substantial surrender of dominion by the person who would otherwise have to pay the tax. They may not change economic status, but merely present different facades. Substantial ownership, business, the operations of daily life, may go on as before. Lawyers who put aside their special interest as advocates, and their inherent fondness for legal subtleties, know that this is so. Taxation will not be the practical matter it is so often said to be until it develops a ruthless capacity to disregard the empty legalisms and the economic pretenses of the family partnership, the family trust, and even the family corporation, in favor of the facts of family life.

receive income from that property.[9] Of course, as stated by the Supreme Court in *Commissioner* v. *Sunnen, supra* (p. 604):

> It has long been established that the mere assignment of the right to receive income is not enough to insulate the assignor from income tax liability.

II

The Tax Court Erred in Holding that the Trust Was Actually the Owner-contributor of the Capital Necessary To Give It Recognition as a Special or Limited Partner for Tax Purposes

In *Commissioner* v. *Culbertson,* 337 U. S. 733, the Supreme Court held that in order to acquire partnership status for tax purposes, it is necessary not only that the alleged partner have contributed either services or capital to the partnership [10] but also that, where such

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[9] The taxpayer also even retained the right indefinitely to use that income since by virtue of paragraph numbered 4 of the special partnership agreement the maximum to which the trust was actually entitled was an account receivable which by virtue of paragraph lettered (d) of the trust indenture the trustees could ultimately turn over to the beneficiary. (R. 53, 75-76.) Use of trust property income already paid to the trustees was also made possible by the provision of paragraph lettered (g) of the trust indenture that the trustees could made loans to the partnership without liability for any resulting losses. (R. 56.) See Section 29.22(a)-21(e)(2) of Treasury Regulations 111, Appendix, *infra.* Further control by the taxpayer-settlor of the trust property income was contained in the provision of paragraph lettered (g) of the trust indenture that approval of the taxpayer-settlor was required for all investments of such income by the trustees. (R. 55-56.) This provision alone would be sufficient to render the trust property income for 1946 taxable to the taxpayer-settlor under Section 29.22(a)-21(e)(4) of Treasury Regulations 111, Appendix, *infra.*

[10] The opinion of the court below seems to emphasize the matter of intent almost to the extent of excluding any other requirement. While the intent of the parties is frequently the ultimate question in determining whether a family partnership arrangement is genuine, of course, parties do not become partners merely by intending to be such. Thus, in the language of the Supreme Court (pp. 739, 740):

> If it is conceded that some of the partners contributed neither capital nor services to the partnership during the tax years in

status is claimed on the basis of a contribution of gift capital, the alleged partner have been the true owner of that capital. Accordingly, the Supreme Court stated (p. 748):

> The cause must therefore be remanded to the Tax Court for a decision as to which, if any, of respondent's sons were partners with him in the operation of the ranch during 1940 and 1941. As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital *of which they were true owners, as we have defined that term in the Clifford, Horst, and Tower cases?* (Emphasis added.)

See also this Court's discussion of the legislative history of Section 340(b) of the Revenue Act of 1951, c. 521, 65 Stat. 452, in *Toor* v. *Westover, supra.*

In the case at bar the taxpayers have not contended that the trust, as a special or limited partner, did, or could under the laws of Hawaii, contribute services to the conduct of the partnership business. The partnership status of the trust, therefore, must rest upon the claim that it was the true owner, and therefore the contributor, of the gift capital. Of course, an alleged partner may be the true owner-contributor of gift capital if he voluntarily puts such capital in or voluntarily leaves it in the partnership. Here, however, as pre-

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question, as the Court of Appeals was apparently willing to do in the present case, it can hardly be contended that they are in any way responsible for the production of income during those years. * * * A partnership is, in other words, an organization for the production of income to which each partner contributes one or both of the ingredients of income—capital or services.

viously mentioned, the donee-trust had no option. It was not free to remain out of the partnership nor free to terminate or transfer its interest once the partnership was created. The gift of capital to the trust was conditioned upon the investment of that capital in the partnership. At the will of the general partners, among whom the taxpayer had the controlling interest, such capital, and also the income attributable to it, was to remain available for partnership use, a use with respect to which the trust, as a special or limited partner, had no voice. Under the circumstances, the trust was not the true owner of the gift capital. Accordingly, the trust was not entitled to recognition as a partner for tax purposes.

CONCLUSION

The decisions of the Tax Court are erroneous and should be reversed.

Respectfully submitted,

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August, 1953.

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U.S.C. 1946 ed., Sec. 22.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183 (b).

(26 U.S.C. 1946 ed., Sec. 182.)

Revised Laws of Hawaii (1935):

CHAPTER 225. PARTNERSHIPS, REGISTRATION OF.

SEC. 6870. *Between individuals.*—A partnership may be formed between two or more individuals for the transaction of any lawful business. A special partnership may be formed between one or more persons, called general partners, and one or more persons called special partners, for the transaction of any business.

* * * * *

Sec. 6880. *Only general partners act.*—The general partners only shall have authority to transact the business of a special partnership.

Sec. 6881. *Special partners may advise*—A special partner may at all times investigate the partnership affairs and advise his partners or their agents as to their management.

Sec. 6882. *May loan money. Insolvency.*—A special partner may lend money to the partnership or advance money for it, or to it, and take from it security therefor, and as to such secured loans or advances has the same rights as any other creditor, but in case of the insolvency of the partnership all other claim which he may have against it must be postponed until all other creditors are satisfied.

Sec. 6883. *Receive interest and profits.*—A special partner may receive such lawful interest and such proportion of profits as may be agreed upon, if not paid out of the capital invested in the partnership by him or some other special partner, and is not bound to refund the same to meet subsequent losses.

Sec. 6884. *May not withdraw capital.* No special partner, under any pretense, may withdraw any part of the capital invested by him in the partnership during its continuance.

Sec. 6885. *Result of withdrawing capital.*—If a special partner withdraws capital from the firm, contrary to the provisions of sections 6883 or 6884, he thereby becomes a general partner.

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.22(a)-21 [as added by T. D. 5488, 1946-1 Cum. Bull. 19, and as amended by T. D. 5567, 1947-2 Cum. Bull. 9]. *Trust income taxable to the grantor as substantial owner thereof.*—

*   *   *   *   *

(e) *Administrative control.*—Income of a trust, whatever its duration, is taxable to the grantor, where, under the terms of the trust or the circumstances attendant on its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. Administrative control is exercisable primarily for the benefit of the grantor where—

*   *   *   *   *

(2) a power exercisable by the grantor, or any person not having a substantial adverse interest in its exercise, or both, whether or not in the capacity of trustee, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest in any case, or without adequate security except where a trustee (other than the grantor or spouse living with the grantor) is authorized under a general lending power to make loans without security to the grantor and other persons and corporations upon the same terms and conditions; or

*   *   *   *   *

(4) any one of the following powers of administration over the trust corpus or income is exercisable in a nonfiduciary capacity by the grantor,

or any person not having a substantial adverse interest in its exercise, or both: a power to vote or direct the voting of stock or other securities, a power to control the investment of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments, and a power to reacquire the trust corpus by substituting other property of an equivalent value.

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